The Gold Standard
The journal of The Gold Standard Institute

The Gold Standard Institute

The purpose of the Institute is to promote an unadulterated Gold Standard

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Editorial

Philip Barton asked me to kick off this issue of *The Gold Standard*. Bear with me as I review some grim recent events. There is a positive message at the end.

Impelled by their dollar-derived irredeemable currencies, every country in the world continues its feckless march towards the oblivion of bankruptcy. Cyprus gave us an instructive example of what the central banks desperately fought to postpone. People think that the government took the money from depositors, but the banks lost it the moment they bought Greek welfare state bonds. Bookkeeping caught up later, followed by the run on the bank.

The next phase is the death of the stock market. The Cyprus stock market is now down over 98%. Not only that, but trading volume has totally evaporated.

Meanwhile in Greece, it is the labor market that has flat-lined. Total unemployment is near 30%, and near 60% for those aged 15-24.

Now, all eyes are turned to Japan. The central bank of the rising sun has been buying bonds for a long time. So it is shocking to see how much it has had to increase its purchases. In 90 days, they increased their holdings from ¥91.4T yen to ¥104.9T, or 15%. Did I say they did this in one quarter? I suspect that purchases this quarter are even more breathtaking. They are desperately flailing in an attempt to stave off what happened in Greece and Cyprus. They should read about King Canute's attempt to hold back the tide.

Two news items recently came from India. First, they increased the tax to import gold for the second time in 6 months (more echoes of King Canute). Second, the World Gold Council announced that it is talking to the Reserve Bank of India about promoting gold as a financial asset.

While it's not yet clear what India may do, they are talking about a topic that the whole world needs to discuss. The gold standard is inevitable. When the dollar collapses, no new irredeemable paper currency will be acceptable to most of the world. Gold will be the only thing that works.

Every leader in every country has a choice. They can deny the problem until their country collapses, or they can take the initiative. The first country to do that will gain a huge and enduring competitive advantage. Honest money makes savings and capital. Contrary to the stale mercantilist propaganda bombarding us today, sound money, savings, and capital is good for a country, its economy, and its people.

Supporters of the Gold Standard Institute have an opportunity to think about how they might bring this message to people and to government. We may just be able to avert collapse. Never forget that unless the world changes trajectory, this will be our destination.

Keith Weiner

News

GoldCore: France prohibits sending currency, "Coins And Precious Metals" by mail.

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The Blade: Jeep suspension kit offered for 1 gold coin.

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Fox News: US pushing to stop all gold sales to Iran - still.

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Signs of the Times: If paper money is not available then gold and silver will be. For many reasons, not everyone chooses to have their transactions recorded. Nothing will more effectively cause the return of gold and silver than a society where paper money has been eliminated – either by collapse or by government withdrawal.

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MineWeb: China demand drives Asian gold bar premiums to record highs.

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WSJ: India increases import tax on gold.

International Man: US government gold paranoia becoming more severe.

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Nehanda Radio: "The world needs to and will most certainly move to a gold standard and Zimbabwe must lead the way." Gideon Gono – governor of the Reserve Bank of Zimbabwe. Hmmm – reads very much like a paper standard to me.

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Business Standard: US working to block gold sales to Iran to undermine rial.

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BBC: Sachin Tendulkar unveils gold coin engraved with his face (for cricket buffs only).

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Odd Spot… (Yahoo): Venezuelan police seize 2500 toilet rolls – who was it said that everyone love socialism until they run out of toilet paper?

Gold is for the Rich… no?

Is Gold, and a 'Gold Standard' really for the benefit of the rich, or is Gold and a Gold Standard actually of benefit to the average person? The short answer is; remember the Golden Rule… no, not the Golden Rule that says 'Do onto others as you wish others do onto you'… but the other Golden Rule, the one that says 'He Who Has the Gold Makes the Rules'.

Today, the American G'man and his top bankster boast over 8,000 Tons of Gold in their vaults. The German bankster has over 3,000 tons, the Italian near 3,000 T… and on and on. The final numbers are a bit vague, but the world's central banksters collectively 'own'… or hoard, or control or whatever you want to call it… tens of thousands of tons of Gold.

In the meantime, average people have almost no Gold (the world population is estimated to hold less than ½ OZ per capita) and the total amount of Gold in (legal) circulation is zero. Guess who makes the rules?

One example of 'making rules' is setting the rate of interest. Mr. Bankster has decreed that he will set a 'ZIRP' policy… that is, a Zero Interest Rate Policy… supposedly to 'stimulate the economy'… and to bring about 'full employment'. By the expedient of buying bonds with newly created Fiat paper, Mr. Bankster keeps the price of bonds artificially, fraudulently high… which is the same as keeping interest rates artificially, fraudulently low.

Explaining exactly how and why high bond prices equal low interest rates is beyond the scope of this article. If you are interested, Google 'bond equation' and you will see the answer for yourself.

Getting on with it, the claim that 'low interest rates stimulate the economy' is a Big Lie. Really? Let's ask our average persons, like our retired couples who live off their life's savings, does ZIRP benefit their 'economy'? With their hard earned cash bringing a miniscule income, far less than the ongoing destruction of purchasing power, so called 'inflation', having to live off their rapidly disappearing capital… ZIRP is hardly of benefit to them, is it?

How about our middle aged couples, saving to pay for their children's education… does ZIRP help their economy? With their savings earning negative real income, with their accumulated wealth being robbed by monetary depreciation… when prices grow far faster than whatever their savings earn… and their wages never even match the rate of monetary depreciation? Hardly. ZIRP is destroying their 'economy' as well.

But surely, the young graduate about to embark on his career, who has borrowed a bunch of money to pay for his education… surely HE must benefit? What? He says "no, man… I borrowed a bunch of money for my schooling, and I can't possibly pay the loan back. I am doomed to live as a debt slave…

I can't get a job in my field of studies the best I can do is flip hamburgers part time for a pittance. I am not even allowed to declare bankruptcy… I am Doomed."

But didn't Mr. Bankster tell us that he was introducing a ZIRP to 'stimulate the economy'? If this were true, if the economy were really 'stimulated', how come our new grad can't find a job? If even he doesn't benefit, then who does? Maybe a businessman? That is another claim by the G'man. That the ZIRP will stimulate business investment, by making 'money cheap'… and surely more business investment will reduce unemployment? Just another Big Lie, I am afraid.

I ran a business, manufacturing metal forming machinery in Canada, for over thirty years… still run the business in fact, but now the work is all being done in China… and the prevailing rate of interest never had a noticeable effect on our business. The only thing that moved our business, either up or down, was demand for our products.

Demand depends on the financial health of our customers, and of the economy. If ZIRP impoverishes most people, it does not do anything but destroy the economy… and this destruction takes most business with it. Believe me, I know… ZIRP took my business into bankruptcy!

Does anyone benefit from ZIRP… fraudulently low interest rates? Come on, it's obvious… big time debtors benefit big time. Can you guess who is the biggest 'big time' debtor of all? Why, surprise surprise… it's the G'man. Uncle Sam owes… wait, I will check usdebtclock.org… geez, hard to read, the numbers keep flashing higher and higher… every second the G'man's debt grows…but as I write this, the official US debt is over $16,800,000,000.

Savor that number for a second or two; it is beyond astronomical… 16 trillion, 800 billion Dollars. Mind numbing. No human mind can imagine even a trillion, never mind multiple trillions… but there it is. The truth is out; Uncle Sam can't afford higher interest rates, so he tells his bedfellow bankster to push interest rates down… regardless of the economic destruction this causes. This is the true reason behind ZIRP… ignore the Big Lie… and just follow the money; Cui Bono… to whose benefit… The G'man is the big beneficiary of ZIRP.

Thus dies the Fiat world economy… but a Gold Standard economy goes in exactly the other direction; not towards death, but towards prosperity. Remember the Golden Rule; he who has the Gold makes the Rules…

During the nineteenth century, the heyday of the Classical Gold Standard… and of the British Empire… England ruled nearly 85 percent of the 'civilized' world… and the Bank of England ran the whole show under the graces of Gold. Care to guess how much Gold the Bank of England had in its vaults during the nineteenth century? During the 'peacable days'? It was not the 8,000 Tons that Uncle Sam has… not the 3,000 Tons that Germany has… no, it was an incredibly tiny 150 to 250 Tons…

This number is in the public records of the Bank of England… if you doubt me, check it your self. The commerce of practically the whole world was well conducted on the basis of a few hundred Tons of gold. Where was the rest of the Gold? Where were the thousands of Tons that were in existence? Why, in the hands of average people; Gold was in circulation as money. Guess Who Made the Rules?

It was every man who made the rules, not a handful of banksters and G'men. But how… how could hundreds of millions of men, nay billions of men make any rules? The answer is laughably simple, once you see the truth. The rule for setting interest rates works like this;

When I earn money, there are only three things I can do with it; spend it, hoard it, or put it to work to earn more money… somehow. There is no other possibility… if you concede that giving money away as a gift is spending. Some spending is mandatory… as I need to buy food, fuel, shelter, clothing… the essentials. Hoarding and 'saving' are optional.

Hoarding has some less unpleasant connotations; we are constantly being told that hoarding is somehow wrong, anti-social, 'primitive'… like a Gold standard is called 'primitive'… but even squirrels have enough brains to hoard, saving food in balmy summer days to last them through the tough winter days to come. Are humans as smart as squirrels?

As far as putting money to work, only entrepreneurs and businessmen truly put their money to work. Average, ordinary people are far too busy earning a living to go into business for themselves. Instead, they look for 'yield' with 'safety'.

This is impossible under Fiat paper… as we already saw. There are no real returns possible without all-out gambling, er speculation. Under Gold, the story is very different. After all, simply hoarding Gold is profitable. The purchasing power of a Gold hoard increases as prices decline. Any earnings from lending money at interest are a bonus.

I would not lend my Gold money, unless I was absolutely certain of getting it back, and was offered sufficient interest income. If you get Gold money, would you not think the same way? Spend some, hoard some, but only lend some if the interest being offered was sufficient to make it worth your while?

I believe you think the same way, although what you consider 'worth your while' may not be the same as what I consider 'worth my while'. Nevertheless, this is the crux of the matter; this is where the rubber meets the road.

If hundreds of millions of people think the same way… that is, choose NOT to lend their money unless they believe it 'worth their while'… then anyone who wants to borrow must offer more interest. The ones who hold the Gold make the rules. Borrowers must follow the rules set by the Gold holders, or they luck out.

With paper this does not work; the 'powers that be' will simply print up more paper, and force rates down… regardless of what I, or what you, or what a hundred million others wish for.

This is why only a true Gold Coin standard can work; actual Gold must be in circulation, in the hands of all… else the teeth are not there. No monetary system with Gold 'backed' (paper) money can ever work. If fraudulent paper is in circulation, and if fraudulent paper is accepted as money, more fraudulent paper will be printed… regardless of promises of 'backing' Indeed, Mr. Bankster may open the door to his vault, show us the Gold sitting there 'backing' our paper… and then print as much paper as he wishes… but he cannot print Gold.

Rudy J. Fritsch
Editor in Chief

Freegold: An Analysis

Wikipedia describes freegold as *"a monetary environment where gold is set free, and has no function as money. Gold is demonetized, and has one function only: a store of value. The function of legal tender changes only slightly: it is a medium of exchange and unit of account, but stripped of the store of value function. In this environment, currency and freegold will coexist to supplement each other, without interacting with each other."* (Link accessed May 12, 2013).

One of the several functions of money is a store of value. Thus, under freegold, gold contains at least one monetary function. Many other commodities also store value. Later the article describes gold being used as a medium of exchange, another function of money, under freegold. Although the article claims that freegold frees gold from its monetary functions, freegold as described in the article seems to fail to achieve this goal.

Today's legal tender, which continues to be legal tender under freegold, is credit money, i.e., paper fiat debt money and its electronic equivalent. Such money can be and is used as a medium of exchange and a unit of accounts. However, it makes a poor unit of accounts because it makes long-range planning extremely difficult. Because fiat money continues to lose value, i.e., purchasing power, at a varying rate, long-term planning becomes almost impossible. Money needs to able to store value, i.e., retain purchasing power over time, to make long-term planning practicably. Moreover, under the current fiat monetary system, interest rates are highly variable. Such variability in interest rates greatly hinders long-range planning. Under the gold standard, interest rates are stable and the value of money varies little over the long-term; therefore, long-range planning is feasible.

The article lists several implications of freegold. Eight of them follow. The reviewer's comments are in parentheses and italics.

1. Savings accounts at banks would decline. People would convert their excess money into gold instead of depositing it into savings accounts. (*People can do this today under the current system. However, in many jurisdictions the current system penalizes them with sales taxes if they convert their legal tender money to gold and with capital gains or income taxes if they convert their gold to legal tender money.*) A reduction in savings could affect the banking system and fractional-reserve banking.

2. Interest rates would reflect expected future purchasing power of the currency. (*Why the government and its central bank would not try to keep interest rates artificially low as they do now is unclear. As governments and banks are the largest borrowers, governments and their central banks have an incentive to keep interest rate low. Low interest rates reduce their cost of borrowing.*)

3. Monetary policy would no longer affect the pool of savings. (*To the extent people save in the form of gold, that may be true. However, converting gold into legal tender money is often a taxable event and thus a loss to the saver. Moreover, people who save with gold do not appear to earn any interest under freegold on their gold savings. The article does admit that people who keep their savings in the form of the legal tender money risk losing purchasing power. However, the article seems to blame the loss more on freegold than on the natural deterioration of fiat money.*)

4. Freegold would remove the need for countries to devalue their currency to make exports cheaper. (*Most countries still adhere to the mercantile idea that exports are good and imports are bad. Consequently, most will still seek to gain an export advantage by destroying their currency. The only solution that the article provides for changing this mind-set is that gold would flow into countries with strong currencies and from countries with weak currencies. This solution works only if the political power of owners of gold exceeds that of the export industry.*)

5. Countries could choose to be paid in currency or gold. (*Is this not using gold as money, a medium of exchange? Freegold is supposed to eliminate all monetary functions of gold except as a store of value. Here it can be used as a medium of exchange.*)

6. Freegold would shift power from those who control the money, where it is today, to the workers, and the owners of capital (gold) and natural resources. (*The unadulterated gold standard does the same thing.*)

7. Freegold would slow the expansion of today's debt-based money because money would be used

only for short -term transactions. (*If long-term loans cease under freegold, financial institutions will no longer make loans for real estate as most of those loans range from 10 to 30 years. Freegold appears to devastate the real estate, construction, and related industries. As these industries are politically much more powerful than gold owners will ever be, freegold is dead before it starts. Moreover, what central bank is going to refuse to buy 30-year bonds of the government that created it and can abolish it? If freegold really does eliminate long-term transactions with the legal tender money, then gold will reenter the monetary system through the backdoor of long-term loans and thus end freegold as gold again becomes part of the monetary environment.*)

8. Freegold would better support Islamic banking and Islamic countries that want to return to a gold standard. (*This seems to contradict the concept of freegold, which seeks to liberate gold from all monetary functions beyond serving as a store of value.*)

The article correctly claims that governments have to suppress the price of gold to mask the U.S. dollar's decline in value. Also, the article claims that freegold removes the need for governments to suppress the price of gold. Why would governments stop trying to conceal the loss of purchasing power of their currencies under freegold? They have as much incentive to hide the poor quality of their currency under freegold as they do under the current system — perhaps even more.

Freegold does end valuing gold held by the government and its central bank at some fictitious low price as is done in the United States. Under the current monetary system, maintaining such fiction is absurd.

Does freegold require governments and central banks to sell their hoards of gold? Apparently it would. With its discussion of the euro and the European Central Bank, the article implies that they do not. Although their notes are inconvertible, central banks use gold as part of the backing for their notes. If gold is to be set free from the monetary environment, then central banks have to sell all their gold. Moreover, at least in the United States where the central bank's notes are obligations of the U.S. government, the government needs to sell all its gold to free gold from the monetary environment.

For freegold to work, governments would have to end all sales taxes, value added taxes, capital gains taxes, and other taxes on gold and converting legal tender currency into gold (buying gold) and gold into legal tender currency (selling gold). Thus, the tax system has to treat gold differently from other commodities. In essence it has to treat gold as though it is part of the monetary system.

With one exception, the unadulterated gold standard accompanied by the real bills doctrine does a superior job of achieving the goals of freegold than does freegold itself. The one exception is that freegold allows governments and their central banks to continue to manipulate the monetary system.

Freegold seems to depoliticize gold more than demonetize it. Depoliticization of gold is a step in the right direction. Freegold should be considered not as an end in itself, but as a step toward establishing the unadulterated gold standard accompanied by the real bills doctrine.

Thomas Allen

Are Covert Operations Underway in the Global Currency Wars

Note: this article is adapted from Vol 4 (May 2013) of the Amphora Report investment newsletter. Anyone interested in subscribing to the AR should email the author at john.butler@amphora-alpha.com

In an age of economic policy activism, including widespread quantitative easing and associated purchases of bonds and other assets, it is perhaps easy to forget that foreign exchange intervention has always been and remains an important economic policy tool. Recently, for example, Japan, Switzerland and New Zealand have openly intervened to weaken their currencies and several other countries have expressed a desire for some degree of currency weakness. In this report, I consider the goals and methods of foreign exchange intervention and place today's policies in their historical context. Also, I examine the evidence of where covert intervention—quite common historically—might possibly be taking place: Perhaps where you would least expect it.

Another Tool in the Toolkit

Over two decades ago, when I was a graduate student of international economics in the US, I had the good fortune to take a course in international economic policy from a former US Treasury official who had worked in the International Affairs division during the 1980s.

Some readers might recall that the 1980s were the decade of the Plaza and Louvre Accords, so named after their respective locations, as the Bretton-Woods arrangements had also so been. This former official had thus been involved in negotiating these historic currency agreements to first weaken and then support the US dollar, respectively. One evening in 1991, while preparing for our final exam in his course, some fellow students and I hosted him for dinner.

Although the primary goal of the wine-laden dinner was to try and glean from our esteemed guest clues as to the questions on the exam, once we collectively relented in that unsuccessful effort, the discussion turned to his experiences at the New York Plaza hotel in 1985 and subsequently at the Paris Louvre in 1987. This became one of the more eye-opening conversations of my life as a student and practitioner of international finance. What follows is my best effort to recall and to paraphrase:

As the conversation turned toward the professor's experiences at Treasury, one student asked, "How did the Plaza and Louvre interventions take place? Is there an optimal way in which countries can intervene in the FX markets?"

"Well it is certainly optimal from the policymakers' perspective if countries on both sides of an exchange rate can agree to cooperate," the professor answered. "This was the case with both Plaza and Louvre, at least initially. With both sides publicly cooperating, and executing their intervention in coordinated fashion, it is the rare, brave, one might say foolhardly speculator who will dare to take the other side.

"More difficult is when a country intervenes unilaterally, especially if they are trying to defend their currency from speculative attack. That is ultimately futile, although if you have some accumulated FX reserves and are clever how you go about it you can nevertheless accomplish quite a bit."

"But reserves are limited, are they not? Once markets sense that a country is running out of ammo, don't they become emboldened to attack more aggressively, forcing the issue?" the student pressed.

"Oh of course there is a limit. We have seen this countless times throughout history. Reserves dwindle, the attack intensifies and all of a sudden in some midnight meeting the government in question gives up and just devalues, either all in one go or in a handful of stages. In my view, once you determine the dam is breaking it is best just to let it break, face the consequences and move on. But that is just my opinion and I suppose if I were facing such pressures myself I don't really know exactly how I would act.

"But I will tell you this: If you are going to intervene from a position of weakness, you had better do everything in your power to burn the speculators. That is what buys you time and that's precisely what you need to defend against the attack: time. When you go into the market, you go in big. You go in when liquidity is low. You go in when people don't expect it. And the moment they come back to attack anew, you go in even bigger. You force the price hard over a short time, ensuring that distinctive chart patterns emerge and on high volume. Speculators will read those charts, assume the trend has reversed, and you will win some of them over to your side, at least for a period of time. That is the way to do it."

"But if the speculators know that is the game plan, will they take the charts seriously?" asked another. "Won't they see that it is all artificial price action, not indicative of anything other than a desperate government exhausting its scarce reserves?"

"Well, you must…" The professor paused for a moment. You could tell he wanted to say something but was unsure how best to say it. Then he continued: "As a good poker player, you must be careful to play your cards close to the vest. Don't show the speculators your hand if you can help it. In fact, consider keeping the intervention secret if you can. Some might figure out what is going on but many won't and they will just assume that the trend is reversing due to natural market causes. It helps if you have friends at the major dealers who owe you a favour or two or at a minimum understand and support the reasons behind the policy."

"Are you saying that covert intervention occurs frequently?" asked another student in astonishment.

"I have no privileged information to that effect. Certainly when I was at Treasury we did no such thing. But then we had no reason to because we had our allies on side and we desired to show our intentions to the markets to get them to do our work for us. But I suspect other countries in a more difficult position have operated in this covert way on occasion and perhaps the

US has done so as well in the past, for example to manage the markets as Bretton-Woods was breaking down. I can only speculate.

I forget the remaining details of that evening, other than a humorous discussion of some of the professor's misadventures when he was a young Foreign Service officer posted to various countries in the 1970s. He certainly did have a good sense of humour and he was also remarkably forthcoming in his discussion of US international economic policy.

Recall that this conversation took place in 1991, the year prior to the 1992 European Exchange Rate Mechanism (ERM) crises that rocked the foreign exchange world and threatened the process of European integration, by then already long underway. Another, less-severe ERM crisis would hit in 1995. A rash of Asian currency crises arrived in 1997, followed by a near-collapse of the Russian rouble in 1998, precipitating a US financial crisis via the now-notorious hedge fund Long-Term Capital Management (LTCM). In all cases, policymakers were active in trying to prevent, manage and clean up after the respective crises. In some cases their actions were out in the open; in others, less so. In still others, their specific actions and interventions behind the scenes probably remain secret to this day.

A Curious Paper on Covert Intervention

Back in 2001, some prominent economists wrote a paper, published in the American Economic Association's prestigious Journal of Economic Literature, titled "Official Intervention in the Foreign Exchange Market." In this paper, the authors discuss the efficacy of foreign exchange intervention and, perhaps surprisingly, they include a brief section on covert intervention specifically, of which the following is an excerpt:

Most actual intervention operations in the foreign exchange market have been—and still are—largely secret, not publicly announced by monetary authorities…

The traditional relevant literature identifies three types of arguments in favor of secrecy of official intervention: arguments based on the central bank's desire to minimize the effects of an unwanted intervention operation (for example because the decision has been taken outside the central bank, e.g. by the Treasury), arguments based on the perceived risk and volatility in the foreign exchange market which might be exacerbated by an announcement of official intervention, and portfolio adjustment arguments. A further explanation may be that ***although monetary authorities intervene in order to target the value of a foreign currency, since the fundamentals of the foreign currency are not necessarily equal to this objective, the monetary authorities do not have an incentive to reveal their intervention operations as no announcement on their activities will be credible … [S]ecrecy of intervention may be an attempt to affect the exchange rate … without triggering a self-fulfilling attack on the currency.*** *(Emphasis added.)*[1]

Now it is not exactly common for published academic journals to contain a discussion of covert activities. How did the authors conduct their research? Who were their sources? Why did the editors allow such opaque, unsubstantiated material to be published without appropriate verification?

Small clues are provided in the authors' respective backgrounds and also in the article acknowledgements: Both authors studied at the University of Warwick in Britain. At time of writing, one worked at the US Federal Reserve and one for the World Bank in Washington DC. The acknowledgements thank a number of prominent fellow academics for their assistance but also mention *three anonymous referees*.

It is therefore not much of a stretch to surmise that sitting economic policymakers, perhaps on both sides of the Atlantic, provided the source material for the section on covert FX intervention discussed above. As for exactly who they might have been, the short list would certainly include those officials working at the time at the US Treasury's International Affairs Division or at the US Federal Reserve on the one side; and at one or more European finance ministries or central banks on the other.

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[1] Sarno, Lucio and Taylor, Mark P., "Official Intervention in the Foreign Exchange Market," Journal of Economic Literature vol. 39 (September 2001). The link is here.

Foreign Exchange Intervention and the Global Financial Crisis

Returning now to our discussion of the history of foreign exchange intervention, as it happened, the Europeans managed to hold integration together through the 1990s. In 1999, against the expectations of many, the euro currency was launched and the leaders of the time hoped that, stronger together than apart, European financial crises would become a thing of the past.

Of course we now know that financial crises are not a thing of the past but the present, and not only in Europe. All major developed economies have been embroiled in protracted financial crises since 2008. Yes, there have been tentative signs of a recovery at times, including recently, and stock markets in the US, Europe and Japan have all risen dramatically of late. The fact remains, however, that policymakers are holding interest rates on the floor while running huge fiscal deficits in a blatant, neo-Keynesian effort to stimulate aggregate demand in the hope that this will lead to an economic normalisation in time.

Well good luck with that. Readers of this report will know that I don't believe that financial market manipulation of interest rates, currencies, stock markets, commodities or anything else for that matter diminishes the need for natural economic deleveraging following a boom-bust cycle. Indeed, manipulations are ultimately counterproductive as they misallocate resources. This misallocation may go unseen for a sustained period but, as Frederic Bastiat explained so eloquently in the 19th century, that doesn't make it any less real or harmful.

As one tool among many, foreign exchange intervention has continued to be publicly and actively used as a policy tool, most recently in Japan, China, Brazil, Switzerland, New Zealand and a handful of other countries. In all of these cases, however, it has been used to prevent or limit currency strength rather than to defend against weakness.

Based on the academic paper cited above, the authorities in these countries have had no need to employ covert intervention tactics as they have not sought to disguise eroding currency credibility and have been seeking to weaken rather than strengthen their currencies, accumulating rather than depleting their foreign reserves in the process.

However, as all major economies seem to prefer currency weakness to strength at present, the world appears to be in the midst of a so-called 'currency war'. The term 'war' implies that countries are failing to cooperate with one another. This in turn suggests that there might indeed be a role for covert operations of some sort at present to weaken currencies without other countries noticing.

Let's consider the evidence. As the professor explained in his comments, covert, non-coordinated interventions would probably leave a 'footprint', that is, they would take place at times of low market liquidity and tend to continue until an important chart pattern has emerged that encourages speculators to reverse the previous market trend, thereby initiating a new one in line with the intervention's objectives.

Looking around various FX rates, there is some evidence that covert intervention has been taking place in Asia. Occasional, sharp overnight moves on unusually high volume have taken place in the Korean won, Taiwan dollar, Indonesian rupiah, Malaysian ringitt and Vietnamese dong. This is of course only circumstantial evidence but it would be odd were profit-maximising economic agents to behave in this way. Given that the authorities in question have the means and quite possibly the motive, and the price action is suggestive, it is entirely reasonable to surmise that some covert intervention has been taking place in the region.

The Future of Covert FX Intervention

If the currency wars continue to escalate as they have of late, it seems reasonable to expect that covert interventions will grow in size, scope and frequency. As it is impossible for all countries to devalue against all others, however, this just raises the stakes in what is, at best, a zero-sum game. At worst, as countries begin to accuse one another of covert currency manipulation, the currency wars will morph into damaging trade wars with tariffs, taxes, quotas, regulations and all manner of restrictive trade practices that, collectively, could slam the brakes on what little global economic momentum remains.

There is one country in particular, however, that has a particularly keen interest in avoiding this: the United States. As the issuer of the world's reserve currency and the world's largest foreign-held public debt, the US wants to ensure that foreigners continue to absorb dollars as reserves. If their preferences were to change in favour of other assets, this would place upward pressure on US interest rates, greatly complicating the Fed's efforts to stimulate domestic growth and reduce unemployment.

Worse, if an outright trade war breaks out, the US will quickly become mired in a severe stagflation, the result of higher import costs, strangled global trade, far fewer dollars being absorbed abroad and associated upward pressure on dollar interest rates. The US would have to make some tough choices.

Many argue that, absent a trade war, foreigners' appetite for dollar assets will not diminish. History suggests otherwise. Central banks actively diversified reserves out of dollars in the 1970s, following the US decision in 1971 to renege on the Bretton-Woods promise to redeem foreign official dollar holdings in gold. By the early 1980s, the dollar share of reserves had fallen dramatically as other currencies and gold took a growing share.

The same has happened in recent years and at an accelerating rate. Central bank gold purchases rose to a post-Bretton-Woods record last year and are continuing at a rapid clip so far in 2013. Private investors also continue to diversify out of dollars.

The US Federal Reserve has been absorbing roughly half of all new US Treasury bond issuance, which has held interest rates artificially low. Were foreigners to dramatically accelerate their diversification out of dollars and into other currencies and gold, the US would face a dilemma: Allow interest rates to rise to stabilise the dollar, triggering a recession and a huge deterioration in government finances; or continue to suppress interest rates but watch the dollar fall sharply, triggering far higher inflation and general economic and possibly also political instability.[2]

There is a third option, however. The US could try to have its cake and eat it too. It could continue to suppress interest rates through QE but it could also covertly intervene to support the dollar in the foreign exchange markets. To do so publicly would be a short-lived, probably disastrous exercise as the US possesses little in the way of foreign currency reserves. Speculators would almost certainly see this as a historic opportunity to force through a major devaluation, reaping potentially huge profits in the process. Thus I consider this highly unlikely.

But consider: the US may have little in the way of FX reserves but it has a huge pile of gold reserves—the world's largest in fact. If the US were to set about covertly intervening to support the dollar amid artificially low interest rates, therefore, it would make far more sense to do through covert intervention in the gold market. Should they follow my former professor's advice, they would sell gold into the market at relatively illiquid times for maximum price effect. They would do so repeatedly until certain technical chart patterns turned in favour of the dollar and against gold, establishing a new trend. And if they succeeded, no one need ever know.

So do I think they will try it? Perhaps. Desperate policymakers sometimes do desperate things. And history is sometimes stranger than fiction.

John Butler
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[2] I wrote about this policy dilemma in much more detail back in 2011. Please see IT'S THE END OF THE DOLLAR AS WE KNOW IT (DO WE FEEL FINE?), Amphora Report vol. 2 (April 2011). Link here.

Theory of Interest and Prices in Paper Currency Part III (Credit)

In Part I, we looked at the concepts of nonlinearity, dynamics, multivariate, state, and contiguity. We showed that whatever the relationship may be between prices and the money supply in irredeemable paper currency, it is not a simple matter of rising money supply → rising prices.

In Part II, we discussed the mechanics of the formation of the bid price and ask price, the concepts of stocks and flows, and the central concept of arbitrage. We showed how arbitrage is the key to the money supply in the gold standard; miners add to the aboveground stocks of gold when the cost of producing an ounce of gold is less than the value of one ounce.

In this third part, we look at how credit comes into existence (via arbitrage, of course) with legitimate entrepreneur borrowers. We also look at the counterfeit credit of the central banks (which is not arbitrage). We introduce the concept of *speculation* in markets for government promises, compared to legitimate trading of commodities. We also discuss the prerequisite concepts. *Marginal time preference* and *marginal productivity* are absolutely essential to the theory of interest and prices. That leads to the last new concept *resonance*.

In the gold standard, credit comes into existence when one party lends and another borrows. The lender is a saver who prefers earning interest to hoarding his gold. The borrower is an arbitrager who sees an opportunity to earn a net profit greater than the rate of interest.

As with all markets, there is a bid and an offer (also called the "ask") in the bond market. The bid and the offer are placed by the saver and the entrepreneur, respectively. The saver prefers a higher rate of interest, which means a lower bond price (price and interest rate vary inversely). The entrepreneur prefers a lower rate and a higher bond price.

Increased savings tends to cause the interest rate to fall, whereas increased entrepreneurial activity tends to cause a rise. These are not symmetrical, however. If savings fall, then the interest rate **must** go up. The mechanism that denies credit to the marginal entrepreneur is the lower bond price. But, if savings rise, interest does **not necessarily** go down much. Entrepreneurs can issue more bonds. Savings is always finite, but the potential supply of bonds is unlimited.

What is the bond seller—the entrepreneur—doing with the money raised by selling the bond? He is buying real estate, buildings, plant, equipment, trucks, etc. He is producing something that will make a profit that, net of all costs, is greater than the interest he must pay. He is doing *arbitrage* between the **rate of interest** and the **rate of profit**.

It may seem an odd way to think of it, but consider the entrepreneur to be long the interest rate and short the profit rate. Looking from this perspective will help illustrate the principle that arbitrage always has the effect of compressing the spread. The arbitrager lifts the offer on his long leg and presses the bid on his short leg. The entrepreneur is elevating the rate of interest and depressing the rate of profit.

Now let's move our focus to the Fed and its irredeemable dollar. The Fed exists to enable the government and favored cronies to borrow more, at lower interest, and without responsibility to extinguish their debts.

People often use the shorthand of saying that the Fed "prints" dollars. It is more accurate to say that it borrows them into existence, though there is no (knowing) lender. The Fed has the sole discretion to create these dollars ex nihilo, unlike a normal bank that must persuade a saver to deposit them. By this reason alone, the Fed's credit is counterfeit. The very purpose of the Fed is to cause *inflation*, which I define as an expansion of counterfeit credit[3].

These borrowed dollars are the Fed's liability. It uses them to buy assets such as bonds or to otherwise lend. Those bonds or loans are its assets. While the Fed can create its own funding, its own liabilities, it still must heed its balance sheet. If the value of its

[3] http://keithweinereconomics.com/2012/01/06/inflation-an-expansion-of-counterfeit-credit/

assets ever falls too far, the market will not accept its liability. Gold owners will refuse to bid on the dollar. Through a process of arbitrage (of course), the dollar will collapse.[4]

What does the government get from this game? It diverts resources away from value-creating activities into the government's welfare programs, graft, regulatory agencies, and vast bureaucracy. By suppressing interest rates and enabling debts to be perpetually rolled, the Fed enables the government to consume much more than it could in a free market. Politicians are enabled to buy votes without raising taxes.

Earlier, I said there is no **knowing** lender. Let's look at this mysterious unknowing lender. He is industrious and frugal, consuming less than he produces, keeping the difference as savings. He feeds this savings, the product of his hard work, into the government's hungry maw. Unfortunately, the credit he extends is irredeemable. The paper promise he accepts has a warning written in fine print: it will never be honored. The lender is a self-sacrificial chump. Who is he?

He is anyone who has demand for dollars.

He is the trader who thinks that gold is "going up" (in terms of dollars). He is the businessman who uses the dollar as the unit of account on his income statement. He is the investor who measures his gains or losses in dollars. He is every enabler who does not distinguish between the dollar and money.

People don't think of their savings in this light, that they are freely offering it to the government to consume. They don't understand that savings is impossible using counterfeit credit.

Now we have covered the counterfeit credit of the Fed, let's move on to cover another prerequisite topic: *speculation*. With *arbitrage*, I offered in Part II a much broader definition than the one commonly used. With *speculation*, I will now present a narrower concept than the usual definition. Let's build up to it by looking at some examples.

The first example is the case of agricultural commodities, such as wheat. Production is subject to unpredictable conditions imposed by nature, like weather. If early rain reduces the wheat yield by 5%, then there could be a shortage. Think of the dislocations that would occur if the price of wheat remained low. Inventories from the prior crop would be consumed too rapidly at the old price. Then, when the reduced new crop was harvested, it would be too late for a small reduction in consumption. Grain consumers would suffer undue hardship.

Futures traders perform a valuable economic function. Their profit comes from helping to drive prices up (in this example) as soon as possible, and thus discourage consumption, encourage more production, and attract wheat to be shipped in from unaffected regions. Good traders study and anticipate nature-made risks to valuable goods and earn their profits by providing price signals to producers and consumers.

Trading commodities futures is a legitimate activity that helps people coordinate their activities. If such traders were removed, the result would be reduced coordination (i.e. waste). Therefore my definition of *speculation* excludes commodities traders.

There are two elephants in the room of the irredeemable currency regime: interest and foreign exchange rates. It is the profiteer in these games who earns the dubious label of *speculator*.

The price of each currency is constantly changing in terms of all others. To any business that operates across borders, this creates unbearable risk. They are forced to hedge. The banks that provide such hedging products must, themselves, hedge. One result is volatile currency markets.

The rate of interest presents the other big man-made risk. Unlike in gold, interest in irredeemable paper is always changing and is often quite volatile. For example, the interest rate on the 10-year Treasury bond has gone from 1.63% to 2.16% just during the month of May. As with currencies, there is a big need to hedge this risk, and hence, a massive derivatives market.

[4] http://keithweinereconomics.com/2012/03/15/when-gold-backwardation-becomes-permanent/

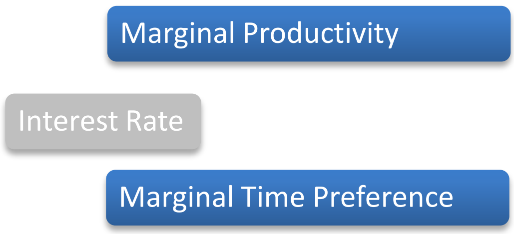
Naturally, volatility attracts traders, in this case the *speculators*. Their gains are not profits from anticipating natural risks to the production of real commodities. They are not skilled in responding to nature. They are *front-runners* of the artificial risks created by the next move of the government or central bank. Worse still, they seek to *influence* the government and central bank to act favorably to their interests.

Unlike the trader in commodities, the *speculator* in man-made irredeemable promises is a parasite. This is not a judgment of any particular speculator, but rather an indictment of the entire dollar regime. It imposes risks, losses, and costs on productive businesses, while transferring enormous gains to *speculators*.

It is no coincidence that the financial sector (and the derivatives market) has grown as the productive sector has been shrinking. A good analogy is to call it a cancer that consumes the economic body, by feeding on its capital. A free market does not offer gains to those who add no value, much less to parasites who consume value and destroy wealth. The rise of the *speculator* is due entirely to the perverse incentives created by coercive government interference.[5]

In light of the context we've established, we are now ready to start looking at interest rates. In the gold standard, the mechanism is fairly simple as I wrote in "The Unadulterated Gold Standard Part III (Features)":

> *This trade-off between hoarding the gold coin and depositing it in the bank sets the floor under the rate of interest. Every depositor has his threshold. If the rate falls (or credit risk rises) sufficiently, and enough depositors at the margin withdraw their gold, then the banking system is deprived of deposits, which drives down the price of the bond which forces the rate of interest up. This is one half of the mechanism that acts to keep the rate of interest stable.*
>
> *The ceiling above the interest rate is set by the marginal business. No business can borrow at a rate higher than its rate of profit. If the rate ticks above this, the marginal business is the first to buy back its outstanding bonds and sell capital stock (or at least not sell a bond to expand). Ultimately, the marginal businessman may liquidate and put his money into the bonds of a more productive enterprise.*[6]



To state this in more abstract and precise terms, the rate of interest in the gold standard is always in a narrow range between *marginal time preference* and *marginal productivity*.[7]

The phenomena of time preference and productivity do not go away when there are legal tender laws. The government attempts to **disenfranchise** savers, to remove their influence over the rate of interest and their power to contract banking system credit.

In the gold standard, when one redeems a bank deposit or sells a bond, one takes home gold coins. This pushes up the rate of interest and forces a contraction of banking system credit. The reason to do this is because one does not like the rate of interest, or one is uncomfortable with the risk. It goes almost without saying that holding one's savings in gold coins is preferable to lending with insufficient interest or excessive risk.

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[5] See my dissertation for an extensive discussion of government interference: A Free Market for Goods, Services, and Money

[6] The Unadulterated Gold Standard Part III (Features)

[7] Interested readers are referred to the subsite on Professor Antal Fekete's website where he presents his theory of interest and capital markets.

By contrast, in irredeemable currency, there is no real choice. A dollar bill is a zero yield credit. If one is forced to take the credit risk, then one might as well get some interest. Unlike gold, there is little reason to hoard dollar bills.

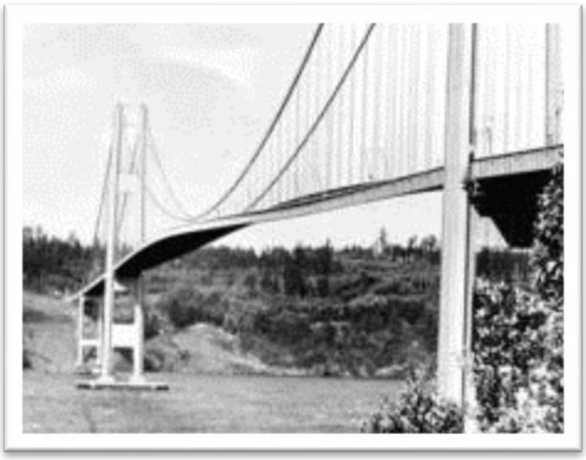
The central planners may impose their will on the market; it is within their power to distort the bond market. But they cannot repeal the law of gravity, increase the speed of light, or alter the nature of man. The laws of economics operate even under bad legislative law. There are horrible consequences to pushing the rate of interest below the *marginal time preference*, which we will study later in this series. The saver is not entirely disenfranchised. He can't avoid harm, but his attempt to protect himself sets quite a dynamic in motion.

It should also be mentioned that *speculators* affect and are affected by the market for government credit. Their behavior is not random, nor scattered. Speculators often act as a herd, not being driven by arbitrage but by government policy. They anticipate and respond to volatility. They can often race from one side of a trade to the other, en masse. This is a good segue to our final prerequisite concept.

The linear Quantity Theory of Money tempts us to think that when the Fed pumps more dollars into the economy, this must cause prices to rise. If there were an analogous linear theory of airplane flight, it would predict that pulling back on the yoke under any circumstance would cause the plane to climb. Good pilots know that if the plane is descending in a spiral, pulling back will tighten the spiral. Many an inexperienced pilot has crashed from making this error.

The Fed adds another confounding factor: its pumping is not steady but pulsed. Both in the short- and the long-term, their dollar creation is not steady and smooth. Short term, they buy bonds on some days but not others. Long term, they sometimes pause to assess the results; they know there are leads and lags. They also provide verbal and non-verbal signals to attempt to influence the markets.

In a mechanical or electrical system, a periodic input of energy can cause oscillation. Antal Fekete first proposed that oscillation occurs in the monetary system. Here, he compares it to the collapse of an infamous bridge:



> *It is hyperdeflation [currently]. The Fed is desperately trying to fight it, but all is in vain. We are on a roller-coaster ride plunging the world into zero-velocity of money and into barter. In my lectures at the New Austrian School of Economics I often point out the similarity with the collapse of the Tacoma Bridge in 1941.*[8]

I will end with a few questions. What happens if the central bank pushes the rate of interest below the marginal time preference? Could this set in motion a non-linear oscillation? If so, will this oscillation be damped via negative feedback akin to friction? Or will periodic inputs of credit inject positive feedback into the system, causing *resonance*?

In Part IV, we will answer these questions and, at last, dive in to the theory of prices and interest rates.

Dr. Keith Weiner

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[8] Antal Fekete: Gold Backwardation and the Collapse of the Tacoma Bridge with Anthony Wile